Asset Allocation Strategy

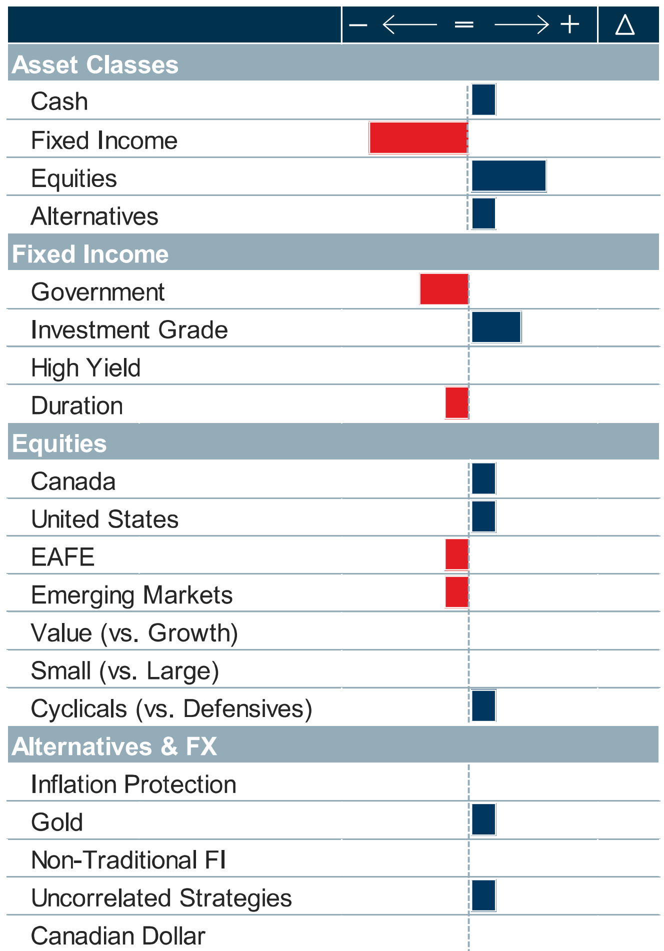
CIO Office | March 2022

Crossing the Rubicon

Highlights

- If 2022 had already been shaping up to be a volatile year for markets with central banks gradually withdrawing their accommodative policies, the advent of the most serious European military conflict since the end of World War II has added a degree of uncertainty of a far more profound dimension.
- Somewhat akin to the counterattack of the Ukrainian people, the most severe damage to markets (and the economy) is observed on the Russian side at present. Looking ahead, the most tangible risk is a stagflationary shock caused by a sudden stop in the flow of energy from Russia, which could throw Europe into recession. However, using this lever could be the *coup de grâce* for the Russian economy, potentially backfiring (even more) against President Putin who has been in power for 22 years.
- In the meantime, disruptions in the commodity world (energy, industrial metals, agriculture, and grain) are likely to complicate the work of central banks. Things could certainly get worse in the short term given the importance of Russia and Ukraine in this market. However, the magnitude commodity price changes is relatively contained for now and, as such, the Fed and the Bank of Canada should stick to their game plans which include a first rate hike of 25 bps in March.
- In sum, the coming weeks are likely to see large fluctuations continue (in both directions) as markets assimilate the impact of the Russian President's military campaign on the global economy which remains difficult to quantify. Yet, history suggests that investors should let the fog of war dissipate, as the months following geopolitical events of this nature often result in gains. Geographically, this backdrop is likely to benefit Canadian and U.S. equities, which are less exposed to Russia. Under the circumstances, we keep our tactical asset allocation (overweight North American equities) unchanged.

Table 1 Global Asset Allocation Views



This table is for illustration purposes only. Bars represent the degree of preference of an asset relative to the maximum deviation allowed from a reference index. The further to the right (left) they are, the more bullish (bearish) our outlook for the asset is. No bars indicate a neutral view. The column under the delta sign (**Δ**) displays when our outlook has improved (↑) or worsened (↓) from the previous month. Consult **Table 3** fto see how they translate into a model balanced portfolio.

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Market Review

Fixed Income

- February was a fairly challenging month for fixed income, despite an increasingly risk-off environment. Indeed, bonds failed to provide much protection against the global equity pullback fuelled by Russia's invasion of Ukraine.
- Canadian long-term bonds and U.S. investment grade securities were hit the hardest during the month. Year-to-date, these two asset classes are down 8.3% and 5.2%, respectively.

Equities

- The S&P 500 continued its downward trend in February, extending year-to-date losses to 8.0%. Just as in January, losses were concentrated in higher-valued sectors such as consumer discretionary, information technology, and communication services. The Index's three defensive sectors (healthcare, utilities, consumer staples) outperformed, and so did energy on the back of surging oil prices.
- The Canadian stock market fared much better; the S&P/TSX even ended the month in slightly positive territory.

FX & Commodities

- Oil prices rose in February, buoyed by mounting uncertainty surrounding the invasion of Ukraine and its consequences on Russian energy exports. As is often the case in periods of elevated geopolitical risk, gold appreciated significantly.
- Despite the circumstances, foreign exchange movements have been relatively small (outside of the Russian ruble). The USD/CAD pair ended the month down 0.2%, while the DXY (value of USD relative to a basket of currencies) barely increased. Still, the Greenback has been on an upward trend over the past 12 months.

Table 2 Market Total Returns

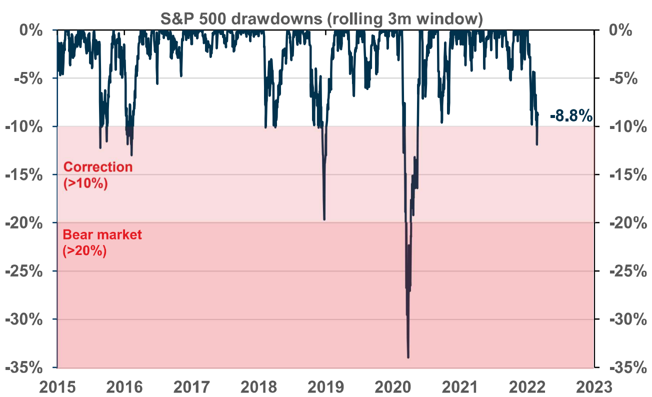
Asset Classes	February	YTD	12 MTH
Cash (S&P Canada T-bill)	0.0%	0.0%	0.2%
Bonds (BofA CA Univ.)	**-1.0%**	**-3.9%**	**-2.3%**
BofA CA Short term	-0.2%	-1.0%	-1.2%
BofA CA Mid term	-0.6%	-2.8%	-1.6%
BofA CA Long term	-2.2%	-8.3%	-4.5%
BofA CA Government	-0.6%	-2.8%	-1.9%
BofA CA Corporate	-1.1%	-3.5%	-2.0%
BofA Inv. Grade ($US)	-2.2%	-5.2%	-3.0%
BofA High-Yield ($US)	-0.9%	-3.6%	0.9%
Preferred Shares	-2.2%	-2.3%	9.1%
CA Equities (S&P/TSX)	**0.3%**	**-0.1%**	**20.1%**
Energy	6.9%	20.3%	59.7%
Industrials	-1.1%	-4.0%	9.8%
Financials	-1.1%	2.9%	31.5%
Materials	12.9%	9.0%	22.9%
Utilities	0.4%	-1.8%	12.6%
Cons. Disc	-4.2%	-6.1%	5.1%
Cons. Staples	-1.7%	-4.3%	24.9%
Healthcare	-2.7%	-11.5%	-49.8%
IT	-18.0%	-34.7%	-29.1%
Comm. Svc.	2.0%	3.7%	29.8%
REITs	-0.9%	-6.6%	20.5%
S&P/TSX Small Cap	5.5%	4.4%	14.2%
US Equities (S&P500 USD)	**-3.0%**	**-8.0%**	**16.4%**
Energy	7.1%	27.6%	55.0%
Industrials	-0.9%	-5.6%	11.8%
Financials	-1.4%	-1.3%	21.6%
Materials	-1.2%	-8.0%	15.5%
Utilities	-1.9%	-5.1%	20.1%
Cons. Disc	-4.0%	-13.3%	8.5%
Cons. Staples	-1.4%	-2.8%	23.4%
Healthcare	-1.0%	-7.7%	17.2%
IT	-4.9%	-11.4%	18.8%
Comm. Svc.	-7.0%	-12.8%	1.2%
REITs	-4.9%	-13.0%	24.6%
Russell 2000 (USD)	1.1%	-8.7%	-6.0%
World Eq. (MSCI ACWI)	**-2.6%**	**-7.3%**	**8.3%**
MSCI EAFE (USD)	-1.8%	-6.5%	3.3%
MSCI EM (USD)	-3.0%	-4.8%	-10.4%
Commodities (CRB index)	**5.5%**	**15.8%**	**41.4%**
WTI Oil (US$/barrel)	8.6%	27.3%	50.7%
Gold (US$/ounce)	6.0%	4.5%	10.2%
Copper (US$/tonne)	3.6%	1.8%	8.5%
Forex (DXY - USD index)	**0.2%**	**0.8%**	**6.4%**
USD per EUR	0.2%	-1.2%	-7.5%
CAD per USD	-0.2%	0.3%	-0.5%

Data via Refinitiv 2022-02-28

Crossing the Rubicon

After a challenging January, tension continued to rise in stock markets throughout February, with the S&P 500 momentarily revisiting correction territory (-10%) as the Russian President crossed the Rubicon and launched a full-scale invasion of its democratic neighbour to the west (**Chart 1**).

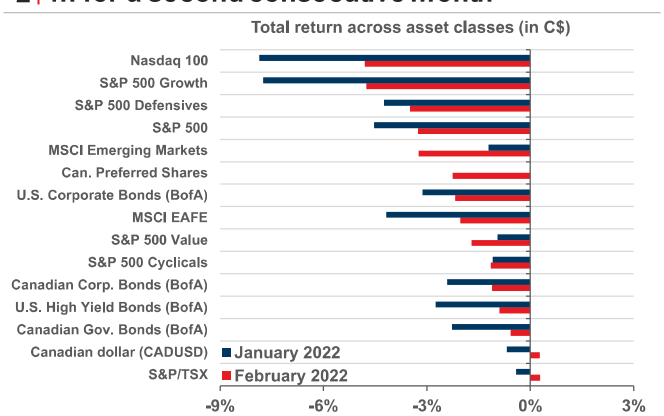
1 | Russia steps forward, stocks step back…



CIO Office (data via Refinitiv).

These historic circumstances resulted in a second consecutive month of broad-based losses across major asset classes (**Chart 2**).

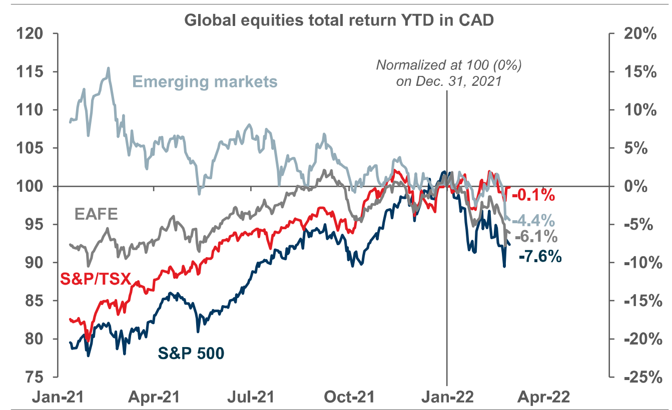
2 | … for a second consecutive month



CIO Office (data via Refinitiv).

Looking back, while the start of 2022 is certainly uncomfortable for investors, it may not be as dire as one might think from a Canadian perspective, as tragic as the situation in Ukraine may be. For instance, Canada's flagship stock index (S&P/TSX) is practically unchanged year-to-date, supported by the higher weighting of energy, materials, and financials within its sector allocation. Naturally, the situation is more challenging abroad, but the losses are fairly limited: between -4% and -8% in C$ after two months in 2022 (**Chart 3**).

3 | A challenging, yet not catastrophic start to 2022



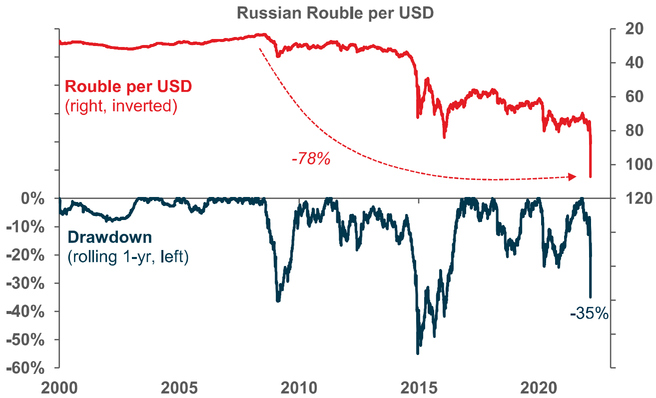
CIO Office (data via Refinitiv).

Looking ahead, large fluctuations are likely to continue (in both directions) as markets assimilate the impact of President Putin's military campaign on the global economy which remains difficult to quantify. In parallel, the upcoming Federal Reserve rate normalization campaign will also be a focal point in the coming weeks. At both ends, nothing can be taken for granted, although the level of uncertainty and the fundamental importance (i.e., beyond the mere impact on financial markets) of the conflict sparked by the Russian leader goes far beyond upcoming decisions on the monetary front. Still, let's take stock of the background surrounding these two important policy makers.

Putin…

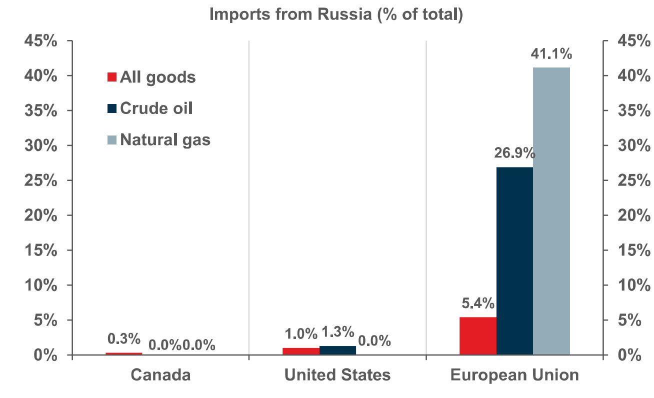
Somewhat akin to the counter-attack of the Ukrainian people, the most severe damage to markets (and the economy) is observed on the Russian side at present. For instance, the ruble reached its lowest level ever following announcements of the withdrawal of a selection of Russian banks from the SWIFT network. Compared to the U.S. dollar, the Russian currency has lost 35% of its value from its high over the past year and 78% from its 2008 peak (**Chart 4**, next page).

4 | A catastrophic collapse for the rouble…



CIO Office (data via Refinitiv).

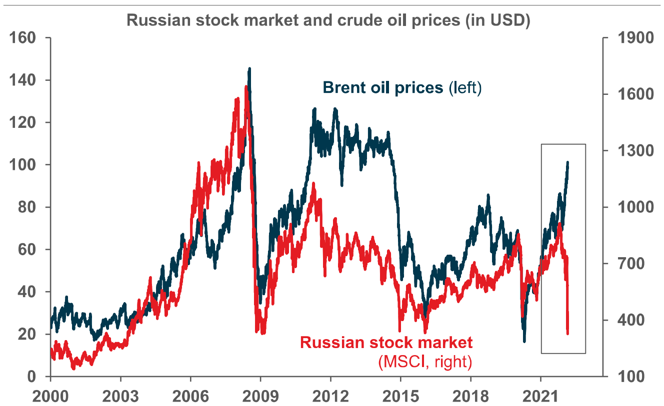
6 | Europe can hardly do without Russian energy



CIO Office (data via Statistics Canada, Canada Energy Regulator, U.S. Census Bureau, U.S. Energy Information Administration, Eurostat).

A similar picture has emerged for the Russian stock market, which has completely collapsed despite the rise in oil prices – a sharp contrast to the typically close relationship between these two assets that attests to the severity of the economic impact for this country (**Chart 5**).

5 | ... as Russia decouples from the world



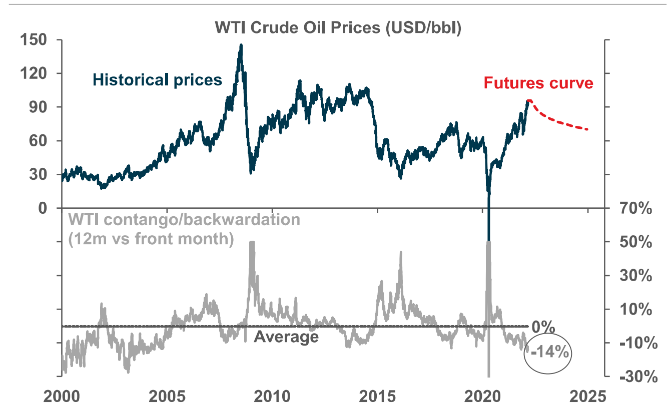
CIO Office (data via Refinitiv).

Naturally, we cannot rule out further deterioration of the situation with greater repercussions for the world economy. For the moment, the most tangible risk is a stagflationary shock caused by a sudden stop in the flow of energy (and, especially, natural gas) [1] from Russia, which could throw Europe into recession given its heavy dependence on Russian energy, unlike Canada and the United States (**Chart 6**).

However, using this lever could be the *coup de grâce* for the Russian economy, potentially backfiring (even more) against its President who has been in power for 22 years now.

Under these circumstances, any projection on oil prices is hazardous, at best. However, we can presume that current prices already carry a significant geopolitical risk premium. This is indeed what the futures curve for the commodity suggests (to some extent), with prices 12 months out trading at their highest discount in nearly 20 years (**Chart 7**).

7 | High risk premium for crude oil spot prices

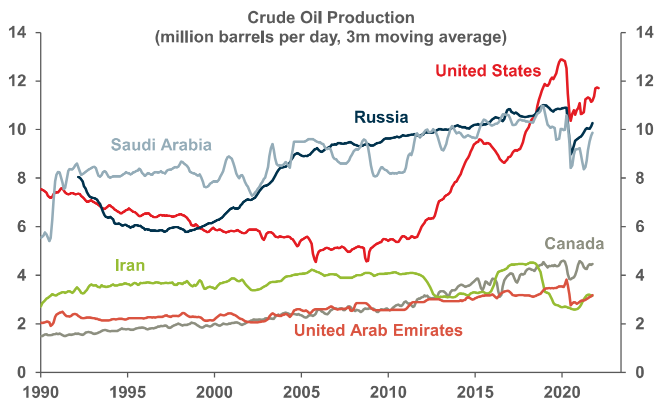


CIO Office (data via Refinitiv).

[1] If the supply of Russian gas to Europe were cut off, could LNG plug the gap? The Economist, February 26, 2022.

Things could certainly get worse in the short term, but the eventual return to the diplomatic route (inconceivable as it may seem at this juncture) should ultimately see this premium reduced. In the meantime, the use of strategic reserves by the United States and OECD countries should provide some stability. In addition, there is likely to be an increase in supply from certain OPEC countries such as Saudi Arabia and the United Arab Emirates, from U.S. shale and, possibly, even from Iran, where the signing of a nuclear agreement with the U.S. could speed up (**Chart 8**).

8 | Other producing countries seek to adjust

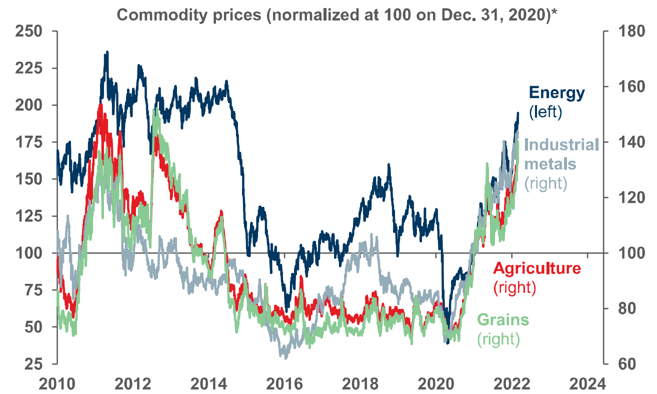


CIO Office (data via Refinitiv).

That said, it's not just energy prices that have been on the rise in recent weeks. Indices of industrial metals (aluminum, copper, zinc, nickel, lead), agricultural commodities (coffee, sugar, cocoa, cotton), and grains (wheat, corn, soybeans) are all at highs not seen in at least 10 years (**Chart 9**).

While the uptrend was already in place before the Russian invasion, chaos in the region – Russia is a major exporter of industrial metals while Ukraine is responsible for 13% and 12% of global corn and wheat exports, respectively[2] – risks further disrupting commodity prices. There's nothing here to simplify the work of central banks trying to bring inflation back to sustainable levels.

9 | Many commodity prices near decade highs

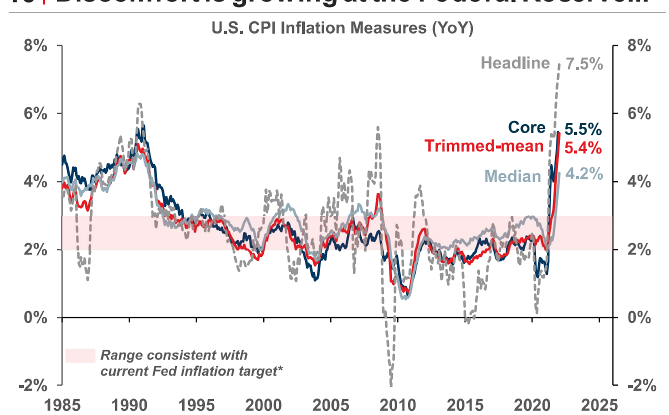


CIO Office (data via Refinitiv).

… and Powell

No question, the rise in inflation is now causing significant discomfort for the Federal Reserve. Beyond the 7.5% annual increase in the headline CPI, it is the broad-based nature of inflationary pressures that has Powell and his colleagues anxious. For instance, indicators excluding the most volatile and outliers such as the trimmed-mean CPI (removes the 8% of CPI components with the highest/lowest one-month price change) and the median CPI (50th percentile of one-month price changes) have recently climbed to multi-decade highs, far beyond the Fed's comfort zone (**Chart 10**).

10 | Discomfort is growing at the Federal Reserve...

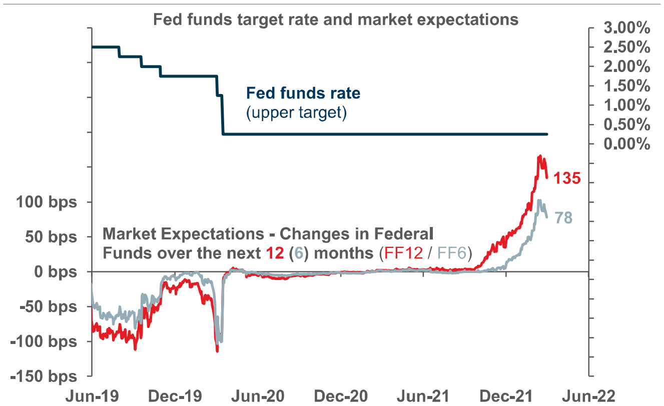


CIO Office (data via Refinitiv). *Since 2012, the Fed targets a 2% PCE annual change which historically corresponds to about 2.5% CPI (+/- a 50 bps margin of error).

[2] Russia's Ukraine Invasion Chokes Food Exports From Global Breadbasket, Wall Street Journal, February 25, 2022.

Faced with such numbers, St. Louis Fed President James Bullard (among the most voluble and hawkish on the FOMC) has repeatedly voiced his desire to raise interest rates quickly in the coming months, perhaps even by 50 bps in March. As a result, expectations of the number of rate hikes over the next 6 and 12 months are now close to 3 and 5, respectively; significantly higher than at the beginning of the year albeit about 25 bps below the peak reached just prior to the Russian invasion (**Chart 11**).

11 | … as reflected in rate hike expectations…



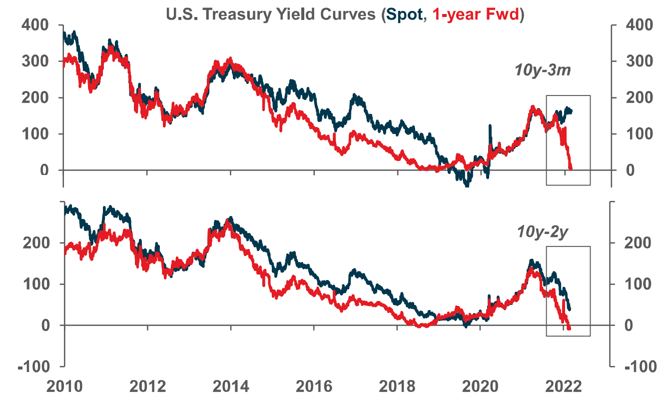
CIO Office (data via Bloomberg).

We shall see if Bullard manages to convince his colleagues by the closing of the March 15-16 meeting. But, one thing is for sure: his interventions have raised the bar for a hawkish surprise, while certain yellow flags visible on financial markets (even before the Russian invasion) are more likely to put a speed limit on the pace of monetary tightening.

For example, yield curves have flattened significantly in recent weeks. They are not yet inverted (historically, a signal the Fed has gone too far in its monetary tightening), but forward rates indicate this could happen in as little as 1 year if the Central Bank moves as fast as Bullard wishes (**Chart 12**).

Simply put, the bond market seems to be more concerned about the risk that soaring inflation will trick the Fed into tightening too quickly than the opposite. This is also the message we are getting from market expectations of long-term inflation,

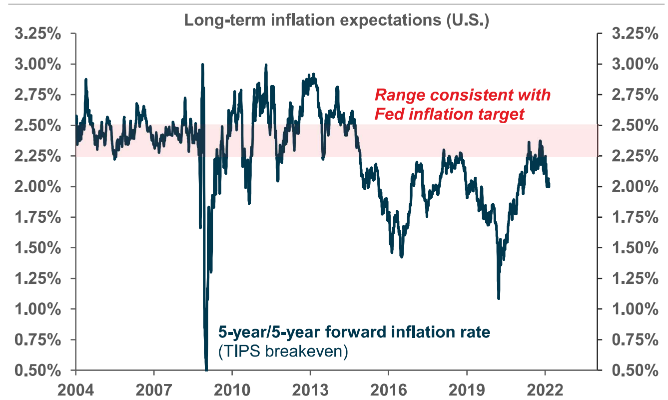
12 | ... but the yield curve calls for caution…



CIO Office (data via Refinitiv).

which have actually fallen below the Fed's target range since the start of the year (**Chart 13**).

13 | … much like inflation expectations…

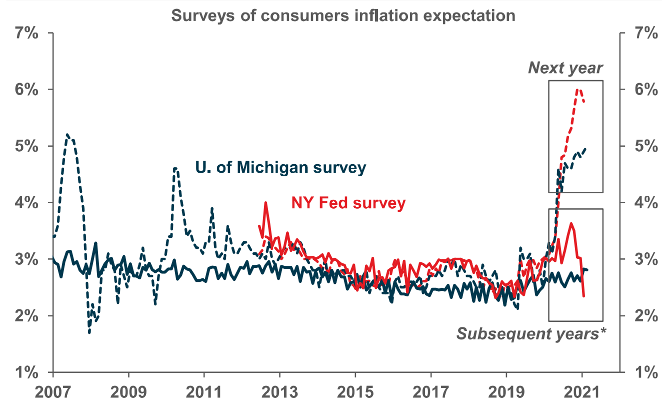


CIO Office (data via Refinitiv).

Household surveys provide a more nuanced yet comparable picture. Although they still expect high inflation in the coming year, consumers' longer-term outlook is either stable (University of Michigan survey) or declining (New York Fed survey) (**Chart 14**, next page).

In short, this backdrop, combined with a high degree of geopolitical uncertainty, suggests that central banks will refrain from negatively surprising markets and will instead stick to their intention of normalizing their policies at a steady albeit gradual and predictable pace. Specifically, our colleagues from the Economics and Strategy team are still forecasting a first hike (25 bps) in March and a total

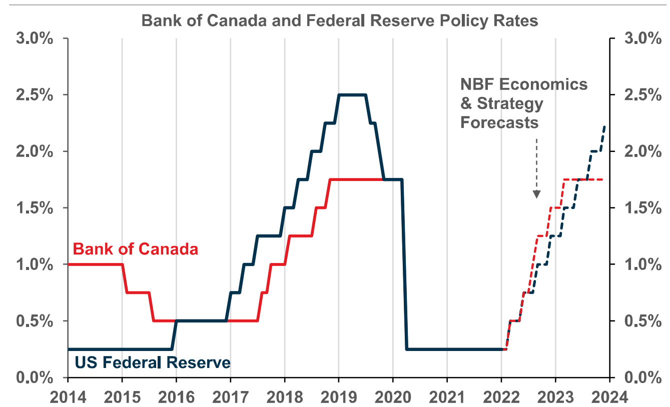
14 | ... high in the short term but not in the long term



CIO Office (data via Refinitiv). *Implied inflation rate from NY Fed survey 3yr expected inflation (equivalent of 2 year inflation in 1 year) and University of Michigan survey 5 to 10 year expected inflation (equivalent of 7.5 year inflation in 1 year).

of 4 for the Fed and 5 for the Bank of Canada in 2022 (**Chart 15**).

15 | A steady but predictable pace of rate hikes ahead



CIO Office (data via Refinitiv).

The Bottom Line

If 2022 had already been shaping up to be a more volatile year for markets with central banks gradually withdrawing their accommodative policies, the advent of the most serious European military conflict since the end of World War II adds a degree of uncertainty of a far more profound dimension. Such a situation calls for caution as the range of potential outcomes remains wide. Yet, for now, spillovers from the Russian invasion are not large enough to completely alter our base-case economic scenario, as tragic as that may be from a human level. Under the circumstances, we are keeping our tactical asset allocation unchanged: overweight in equities and cash, and underweight in bonds. Geographically, we continue to favour North American equities over EAFE and emerging markets.

Looking at more than 8 decades of stock market movements during times of military conflict, we see that it is actually the month before the event that tends to be the worst (positive only 25% of the time with an average return of -2.1%), while the following 3 months often see gains (positive 73% of the time with an average gain of 3.7%). In addition, the average maximum decline is approximately 12%, almost exactly what the U.S. stock market has experienced since the beginning of the year (**Chart 16**, next page). These historical trends do not guarantee anything for the immediate future. They do, however, highlight (1) the forward-looking nature of markets and (2) the fact that they ultimately depend on economic growth, which can sometimes contrast with the grim geopolitical reality.

Geographically, this environment is likely to further favour North American equities – naturally less exposed to Russia – which already displayed a positive signal from our relative momentum model (**Chart 17**, next page).

On the one hand, the pro-cyclical nature of Canadian equities should continue to be an advantage in an environment of sustained global growth and high commodity prices. On the other hand, the defensive properties of the U.S. market and their quality bias should be beneficial in the event of a larger economic impact, while their more difficult start to the year places them in a position to outperform on the rebound when the dust settles.

Finally, the outlook remains poor for bonds, which hardly served as a hedge in February. Nevertheless, the worst could be behind for the asset class in the short term as a consolidation around the 2% level should take shape for U.S. 10-year yields. Indeed, this level is consistent with the Fed's currently discounted terminal rate outlook

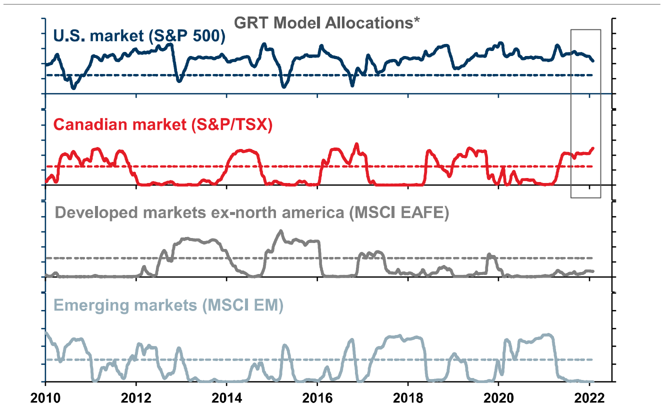
16 | Historical perspective of stocks in times of military conflicts

S&P 500 price changes during geopolitical (military) events since 1939

Event date	Geopolitical (military) event	Before the event			After the event				Max drawdown*
		-3m	-1m	-1w	+1w	+1m	+3m	+12m	
2022-02-24	*Russia invades Ukraine*	*-10.1%*	*-3.0%*	*-5.6%*	*?*	*?*	*?*	*?*	*-11.9%*
2014-02-20	Start of Russian occupation in Crimea	2.7%	-0.8%	0.5%	0.9%	2.4%	3.2%	15.4%	-5.8%
2003-03-20	Initial U.S. air strike in Iraq	-1.9%	2.7%	8.7%	-0.5%	2.2%	15.6%	27.0%	-14.1%
2001-10-07	U.S. air campaign starts in Afghanistan	-10.0%	-3.2%	2.9%	1.9%	2.9%	9.4%	-25.5%	-20.9%
2001-09-11	September 11 attacks	-12.9%	-8.2%	-3.6%	-4.9%	-3.3%	4.3%	-16.8%	-23.1%
1991-01-17	Gulf War (U.S. intervention)	5.8%	-4.2%	1.5%	4.4%	15.2%	23.5%	32.5%	-6.1%
1990-08-02	Iraq invades Kuwait	6.3%	-1.3%	-0.4%	-4.8%	-10.4%	-14.5%	8.9%	-19.9%
1982-04-02	Falklands War	-7.1%	2.6%	0.5%	2.1%	2.3%	-4.5%	34.5%	-12.7%
1968-01-30	Tet Offensive (Vietnam War)	-1.5%	-3.2%	-0.7%	-1.6%	-3.0%	4.4%	9.8%	-9.3%
1967-06-05	Six-Day War	1.7%	-4.8%	-1.3%	2.0%	1.2%	4.3%	11.8%	-6.5%
1964-08-02	Gulf of Tonkin incident	3.8%	0.7%	-0.3%	-1.6%	-1.6%	2.0%	2.7%	-3.2%
1962-10-16	Cuban Missile Crisis	-1.0%	-2.8%	0.4%	-4.0%	3.8%	13.8%	27.4%	-10.5%
1956-10-23	Suez Crisis	-6.3%	-0.8%	-1.3%	0.4%	-2.9%	-4.0%	-11.9%	-10.8%
1950-06-25	North Korea invades South Korea	9.0%	2.4%	0.9%	-7.6%	-8.7%	1.6%	11.3%	-14.0%
1941-12-07	Attack on Pearl Harbor	-8.7%	-2.7%	2.2%	-6.3%	-2.5%	-12.4%	0.4%	-20.1%
1939-09-01	Nazi Germany invades Poland	-2.1%	-8.1%	2.9%	11.8%	14.4%	9.1%	-6.1%	-10.8%
Average		**-2.0%**	**-2.2%**	**0.4%**	**-0.5%**	**0.8%**	**3.7%**	**8.1%**	**-12.5%**
Median		**-1.7%**	**-2.7%**	**0.4%**	**-0.5%**	**1.2%**	**4.3%**	**9.8%**	**-11.4%**
% Positive		**38%**	**25%**	**56%**	**47%**	**53%**	**73%**	**73%**	

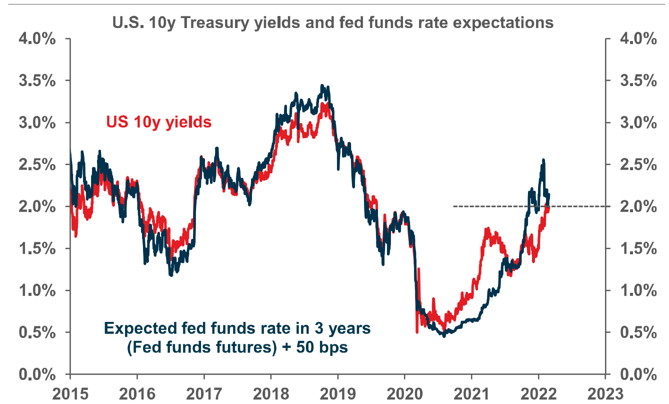
CIO Office (data via Bloomberg).

17 | North America is in a good position



CIO Office (data via Refinitiv).

18 | 10-year yields: consolidation near 2% in store?



CIO Office (data via Refinitiv, Bloomberg).

(**Chart 18**), which should not change too much if the Fed sticks to its game plan as we expect.

Table 3 Global Asset Allocation - Model Portfolio Weights (in CAD)

	Benchmark		Model Portfolio				Comments
	Total	Asset Class	Total		Asset Class		
			Allocation	Active Weight	Allocation	Active Weight	
Asset Classes							
Cash	0%	-	2.0%	2.0%	-	-	With above-trend global growth and limited recession-risk, the outlook for equities compares favourably to bond markets. Alternatives allow for better control of the total risk of the portfolio and offers protection against sustained inflation. A modest cash position provides an extra level of prudence, given relatively low risk-reward prospects across asset classes and heightened geopolitical uncertainties.
Fixed Income	40%	-	30.0%	-10.0%	-	-	
Equities	60%	-	64.0%	4.0%	-	-	
Alternatives	0%	-	4.0%	4.0%	-	-	
Fixed Income							
Government	28%	73%	16.8%	-11.2%	54%	-18.8%	Accommodative monetary conditions and strong economic activity should lead corporate bonds to outperform government securities. For risk control purposes, we are sticking to investment grade credit. Treasury yields should rise modestly as central banks begin to normalize their policies, but we expect real yields to remain negative.
Investment Grade	12%	27%	14.2%	2.2%	46%	18.8%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	*8.1 yrs*	-	*7.4 yrs*	-0.7 yrs	-	-	
Equities							
Canada	21%	35%	23.5%	2.5%	37%	1.8%	Prevailing uncertainty argues for a diversified approach. Canada and the U.S. should outperform under a backdrop of slowing but strong global growth and heightened geopolitical tensions in Europe. In EM, we favour cyclical and value sectors (RAFI Fundamental). In the U.S, we favour the high-quality (MSCI Quality) dividend-paying (Div. Aristocrats) companies and the equal weight index for their diversified and cyclical properties.
United States	21%	35%	23.5%	2.5%	37%	1.8%	
EAFE	12%	20%	11.6%	-0.4%	18%	-1.8%	
Emerging markets	6%	10%	5.3%	-0.7%	8%	-1.7%	
Alternatives							
Inflation Protection	0%	0%	0.0%	0.0%	0%	0.0%	A systematic quantitative strategy that takes advantage of market trends while aiming for maximum decorrelation with equities and tight control of volatility (NALT) play an important role as diversifier. Gold prices may underperform if real yields rise, but remain an inexpensive insurance against the possibility that inflation continues to surprise to the upside.
Gold	0%	0%	2.0%	2.0%	50%	50.0%	
Non-Traditional FI	0%	0%	0.0%	0.0%	0%	0.0%	
Uncorrelated Strategies	0%	0%	2.0%	2.0%	50%	50.0%	
Foreign Exchange							
Canadian Dollar	61%	-	57.5%	-3.5%	-	-	Our overall portfolio strategy places us overweight in U.S. dollars versus our benchmark. Although we don't expect the Canadian dollar to depreciate significantly, we maintain this positioning for risk management purposes as the U.S. dollar offers attractive historical properties from a portfolio construction standpoint, especially paired with gold.
U.S. Dollar	21%	-	25.5%	4.5%	-	-	
Euro	5%	-	4.4%	-0.2%	-	-	
Japanese Yen	3%	-	2.9%	-0.1%	-	-	
British Pound	2%	-	1.6%	-0.1%	-	-	
Others	9%	-	8.0%	-0.7%	-	-	

CIO Office. The fixed income benchmark is 100% FTSE Canada Universe. There are no alternative assets in the benchmark as their inclusion is conditional on improving the risk/return properties of traditional assets (60/40). The amplitude of the color bars under the "Active Weight" columns are proportional to the maximum deviations of the portfolio (+/- 10% for stocks and bonds, +10% in cash, +20% in alternative assets).

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General

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